

lobbyists and economists to shape the debate is reduced. Moreover, some in the telecom manufacturing community and Silicon Valley are likely to join the Bells in pushing for regulatory relief as they fear maintenance of the status quo will exacerbate the cuts in telecom capital spending. Finally, the Bells might be successful in some of the court challenges to the specific state rate settings.

But a quick kill of UNE-P is an uphill battle. In addition to having to make persuasive policy arguments, the Bells will have to overcome a number of political hurdles to succeed.

The Bells can't win everything and broadband relief is easier politically than eliminating UNE-P in a flash cut. The FCC has teed up numerous telecom rulemakings but at their core, they will address two fundamental issues: how to regulate the current Bell network to enable telephony competition and how to regulate the Bell network as it offers broadband. While these issues raise many separate policy decisions, and while we believe the Bells are likely to improve their position as a result of the proceedings, it is a basic rule of Washington that no one wins everything. We think it unlikely that the Bells will get what they want on both broad sets of issues. For a number of reasons, we think it is easier for the FCC to grant the Bells relief on broadband than UNE-P. Given the precedents, radically changing the UNE rules now would be more disruptive than clarifying broadband rules. Chairman Powell welcomed the Supreme Court's May decision in the TELRIC case by saying it was good because it finally gave some certainty to the pricing issues. While every chairman has an opportunity to change the direction of FCC policy, it would be improbable for Mr. Powell to change direction on some of the FCC's core current policies, given his view on the value of certainty. Further, even if the FCC did adopt new rules for implementing TELRIC, it is unlikely the FCC would require all states to immediately redo their existing rates. Just as important, it is easier to provide the Bells relief for investments in networks for new, broadband services than to grant them relief in a way that immediately raises competitors' costs to the point at which they would have to drop their voice services or dramatically raise prices for millions of customers. An FCC move to scrap UNE-P in a flash cut could spark a consumer and political backlash -- and the potential force of such a backlash is growing. By adding hundreds of thousands of new local customers (and possibly millions by the time of a decision), the latest WorldCom and AT&T local offensives are changing the facts on the ground and increasing the risks for the Commission.

Moreover, broadband regulation was not as fully debated at the time of the Act. Therefore, in combination with the fact that cable is winning the majority of broadband connections, there is more sympathy for the Bells position on deregulating investments in new services. Certain changes, such as deregulating access to remote terminals, faces limited political opposition as so few CLECs are actually seeking such access. This is not to suggest that the Bells will easily win everything they seek in the broadband proceedings. There are a number of issues, such as the impact on universal service, that are causing great concern at the agency and on Capitol Hill. Nonetheless, we think it will be generally easier for the Commission to grant some relief for the Bells in how they invest in the broadband networks of tomorrow than give relief that eliminates existing consumer choices today. Even if the Bells win at the federal level, they will have a difficult time prevailing in the states. If the Bells succeed at the FCC in changing TELRIC or eliminating unbundled switching, we believe it is likely that they will meet stiff resistance in the states, particularly those states that have seen significant market penetration through UNE-P. A number of state regulators have already suggested that they view the FCC decisions regarding what constitutes a UNE as essentially advisory. If the FCC eliminates UNE requirements, many state commissions believe they have a right to retain existing UNE rules under prior state regulatory orders or state law. Many states have implemented unbundling as part of a price-cap/alternative-regulation plan. Some states are going to be reluctant to eliminate the platform for what they see as the only serious competition benefiting Bell

consumers. While the Bells would like the FCC to preempt the states, the Bells own position on states' rights in the early days of the implementation of the Act gives the FCC plenty of political cover for not intervening. Further, Republicans generally are more reluctant to preempt the states. The FCC has recently taken action, such as in the Customer Proprietary Network Information (CPNI) proceeding, to explicitly welcome state modification of FCC rules. Any effort by Chairman Powell to preempt state action is likely to cause a negative reaction by some who are generally supportive of him.

We also note an FCC move to pare back UNE-P requirements would be subject to immediate legal challenge from the states and local competitors. Of course, the Bells could also challenge an FCC decision that they believe does not go far enough. Either way, however, we believe both the FCC and the Courts are likely to favor maintaining the status quo to avoid market disruptions until the case is definitively resolved, which could take two or three years.

Attacking UNE-P changes the principal Bell message of deregulating broadband. For the last several years, the Bells have been trying to have their broadband investments deregulated, principally through the Tauzin-Dingell legislation, which passed the House but has stalled in the Senate. By focusing on advocating for new rules for new investments, they sent a message to government officials that deregulating competitors' access to the current telephone network, while welcome, was of a lesser priority. While the Bells see no policy contradiction in asking for both broadband relief and UNE-P, in terms of their political message, the Bells' intensified drumbeat on UNE-P adjusts their message in a way that we believe inevitably makes it less effective.

The UNE-P debate forces the regulators to confront how they will stimulate competition and the Bells to confront how they want to be treated. The UNE-P debate is particularly important, as the decisions will shape both market structure and investment incentives for all telecom players. The debate forces regulators to confront whether they are willing to wait for full, inter-modal competition or feel the need to generate a greater competitive dynamic now. The great hope of regulators is that cable and wireless will fully compete some day with the wired phone network eliminating the need for much regulation. While cable modem service and wireless have affected the provision of non-primary residential phone lines, they have not yet affected primary residential lines in a way that we believe would cause regulators to conclude that regulation is no longer necessary. Moreover, given the current capital constraints on cable and on the non-Bell-affiliated wireless companies, the regulators have to question how long it will be before full facilities-based competition is available.

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 Bells Retrain Guns on UNE-P, but Quick Kill Unlikely part 3

The debate forces the Bells to confront how they want to be treated. The Bells want to be deregulated, preferably without having to face any significant competition for their primary line service. We believe such a goal, however, is unrealistic. We do not think they will be successful on either the federal or state level in advocating for deregulation without primary line competition. If the Bells are successful in eliminating UNE-P, we think it will mean continued retail regulation at the state level, which will also have the affect of distorting investment incentives for the Bells. For example, one alternative is for the Bells to accept the UNE-based competition and then challenge the state retail regulation. Certainly the Bells could argue that if the wholesale rules are working well, there is no need for retail regulation. This approach was adopted by VZ in New York where, in effect, VZ received a \$2 month increase in residential phone rates in exchange for TELRIC rate decreases. For the Bells, this tactic at least has the merits of keeping a significant percentage of the revenue in the Bell network. While we don't believe the Bells will adopt this approach, we note it to suggest that the critical question is not whether the Bells' core telephone network will be deregulated -- it is how it will be regulated until facilities-based competition for its primary lines spreads more broadly, and then what will the Bell revenue stream look like when that happens. In this regard, we note that while UNE-P does in the short term hurt Bell economics, in the long term, the Bells do have significant defenses against such competition. As noted above, VZ, the leading Bell in long-distance entry, has already proven it can stop the tide of UNE-P line encroachment. We believe VZ's intensified efforts to sell bundles will help even more. We think the other Bells are likely to follow VZ's lead in using bundles as a defense to UNE-P. (For a review of the Bell advantages in Bundling see our report, The Battle of the Bundles, June 2002.)

The Bells' real nightmare - cable using UNE-P to ramp up. Ed Whitacre, CEO of SBC, said that AT&T and WorldCom were "abusing" UNE-P because they had no intention of building their own facilities. We note that while UNE-P is no doubt having a negative impact on the Bells, it would be far more damaging for the Bells if a facilities-based competitor, most notably cable companies, used UNE-P to attract a sufficient number of customers to justify the incremental investments in their own networks, to build up their back office systems and marketing while generating revenues, and then to migrate the customers entirely off the Bell network. While we have no indication that anyone in the cable industry is contemplating such a strategy, (though SBC has asked the FCC to prohibit the merged Comcast/ AT&T Broadband cable company from using UNE-P) and we believe any such move by cable could set off a heightened political battle in which the Bells would receive greater deregulation, we note that UNE-P presents a way for cable companies to ramp up their telephony business in a more capital-efficient manner while being consistent with the ultimate goal of facilities-based competition. We also note that in the long-run, the continued growth of wireless and data will take an increasing share of telecom revenues.

Summary

Additional Information Available Upon Request.
 Investment Rating: B-Buy, H-Hold, S-Sell
 Risk Rating: 1-Low, 2-Average, 3-High

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